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SUBMITTED TO THE APPROPRIATIONS COMMITTEE
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Chairman Bye, Chairman Walker, and members of the Appropriations Committee, thank you for the opportunity to provide testimony on House Bills 5031, 5032 and 5109 and Senate Bill 21.

<u>An Act Concerning The Expenditure Cap and Reducing Long-Term Liabilities (House Bill 5032)</u>

In House Bill 5032, the Governor laudably proposes appropriating $100 million of the Fiscal Year 2014 surplus to the State Employees Retirement Fund ("SERF"), over and above the actuarially recommended contribution ("ARC"). This provision is worthy of your support and would be viewed favorably from a credit perspective. In addition, another sensible provision of this bill would exclude future contributions above the ARC -- to either SERF or the Teachers' Retirement Fund -- from being included in calculating the State's spending cap. I support these provisions.

As principal fiduciary of the Connecticut Retirement Plans and Trust Funds, I have long urged the Governor and the General Assembly to appropriate greater amounts to pay down the pension liabilities that grew in large part because of poor funding decisions made decades ago. Currently, SERF has an unfunded liability of $14 billion. While the long-term investment returns of our pension fund has essentially rebounded since the financial crisis that wiped out a decade of gains, investments alone cannot eliminate the liability. Even during favorable market conditions, I have stressed over the years that no portfolio composition could earn enough to make up for the State contributing less than the full contribution determined by the plan actuary – not without assuming undue risk.

That said, the additional contribution of $100 million in FY14 can grow to as much as $400 million by the end of the amortization period in 18 years. In addition, this additional contribution could reduce future scheduled contributions by as much as $185 million over this same period.

The bill also takes a step in the right direction by removing some portion of pension contribution payments from the Constitutional spending limit. The expenditure cap should, and largely does, recognize current spending rather than spending for debt service. Excluding payments above the ARC only, for both the state employee and teacher pension plans, would be consistent with the exclusion of appropriated debt service.

For these reasons, I strongly support the Governor's proposals in House Bill 5032.

<u>An Act Concerning The Budget Reserve Fund (House Bills 5031 and 5109)</u>

Two bills before you today would increase the Budget Reserve Fund ("BRF"). The Governor has proposed House Bill 5031, and Representatives Flexer and Rojas have introduced House Bill 5109.

Bolstering the BRF is a win-win proposition for the State, given that it has been a recurring theme in the evaluation of our creditworthiness by the major credit rating agencies. Raising the upper limits underscores the State's commitment to fiscal discipline.

Both bills would increase the maximum amount the BRF may hold, which is currently ten percent of a current year's net General Fund appropriations. The Governor's bill would increase the maximum to 15 percent of the General Fund and the representatives' bill would increase the maximum to 20 percent.

I support both bills' efforts to establish greater fiscal stability for periods of economic turmoil.

Military Medals (Senate Bill 21, Section 13)

I strongly support the initiative created in section 13 of Senate Bill 21 to safeguard and attempt to locate rightful owners of military medals found in abandoned safe deposit boxes.

If enacted, this bill would require banks and financial institutions to give military medals found in unclaimed safe deposit boxes to the State Department of Veterans' Affairs in accordance with procedures established by the Treasury. The Treasury would make information available to the public, including the posting of pictures of the medals on the office's website, to try to reunite the medal with the veteran who earned it or with the owner's heirs.

This amendment to the unclaimed property statutes enables veterans and their families the ability to have the medal that commemorated the veteran's courage while serving our country. It is a good measure, and ought to pass.

Soldiers Sailors and Marines Fund (Senate Bill 21, Section 13)

Recently, there have been questions about the Soldiers, Sailors & Marine Fund ("SSMF") regarding income, distributions and investment performance. I would like to answer these questions as well as clarify the actual numbers — while offering some insight into trends driving distributions and investment performance of the SSMF.

Certain provisions of SB 21 would impact the Soldiers, Sailors and Marines Fund (SSMF). Of particular interest to me, as fiduciary of the assets of the SSMF, is a provision that would guarantee a stream of income in the amount of $2 million annually for payment of benefits to veterans. This amount would first be payable from interest earnings on the SSMF and, if necessary, from the corpus of the Fund. None of this annual distribution could be used to pay the administrative expenses of the American Legion. Any investment income over this $2 million threshold would be reinvested in the SSMF, and any funds not expended for benefits would likewise be added to the principal of the Fund.

I support these changes, because the beneficiaries of the SSMF – the veterans that have served our country in conflicts over the course of decades -- deserve the assurance of a steady source of income for the payment of benefits that so many desperately need. Under current law, which limits the payment of benefits to interest earnings – and thereby constrains the available investment options -- we have had to employ a very conservative strategy in order to minimize volatility and ensure consistent payments for veterans. Allowing for use of the corpus in any given year would provide more flexibility in terms of the tolerance for investment in riskier, potentially higher return investment strategies.

With that said, I'd like to comment on the current statutory framework and its impact on how the Treasury has invested the assets of the SSMF.

The assets of the SSMF are overseen by the State Treasurer and are part of the Connecticut Retirement Plans and Trust Funds ("CRPTF"). The Fund's investment objective and asset allocation policy are adopted by the Treasurer and approved by the Investment Advisory Council. The SSMF "system" is comprised of the SSMF Trust Fund, which is under the purview of the State Treasurer, and the SSMF State Agency, which is completely independent of the State Treasurer.

Trends in Distributions for Benefits

For Fiscal Year 2013, the distribution of income was $1.9 million. Over the last ten fiscal years, the average annual SSMF distribution was $2.6 million.

FY	2013	2012	2011	2010	2009	2008	2007	2006	2005	2004
	$1.9m	$2.3m	$2.5m	$2.8m	$3.1m	$2.9m	$2.6m	$2.6m	$2.6m	$2.7m

Distributions have fallen, due in large part to the historically unprecedented low interest rate environment, and not simply the result of investment performance. By statute, distributions from the SSMF are confined to income generated from interest and dividends. The income available to distribute from interest and dividends is driven by (1) the percentage of assets invested in income generating securities; and (2) the yields on those securities.

Over the last decade, falling inflation, coupled with efforts by the Federal Reserve to fight deflation, have sent bond yields to levels not seen in quite some time.
The ten year US Treasury yield fell from 6.03% at the end of Fiscal year 2000 to 2.48% at the end of Fiscal Year 2013. The average SSMF distribution has fallen from 5.7% to 2.8% during this horizon.

This market environment has hampered the SSMF's ability to generate income available for distribution. Yet, despite this, the SSMF has been able to distribute a steady stream of income while protecting the underlying principal. As long term investors, we expect the portfolio's income generation capacity to increase as interest rates return to normal levels.

Investment Yield

Yield is generally defined as the income generated from securities paying interest and dividends. But "yield" is only one part of a portfolio's total return. The total return of the SSMF includes not only payments received from interest and dividends, but also capital gains (both realized and unrealized) that occur due to changes in the market value of the underlying investments. It is important to recognize that the distributions from the SSMF are only a <u>subset</u> of total return. The table below shows that the SSMF has generated total returns over the long term that have been superior to the income generated: The ten year average return for the SSMF as of June 30, 2013 was 5.77%, the average annual income distribution over this same period was 4.18%.

(Fiscal Year)	2013	2012	2011	2010	2009	2008	2007	2006	2005	2004
Income	2.8%	3.4%	3.8%	4.5%	5.2%	4.7%	4.2%	4.3%	4.3%	4.6%
Total Returns	5.2%	7.0%	8.7%	13.8%	-1.4%	3.3%	8.2%	1.7%	7.7%	4.2%

As a result, even with all interest and dividends distributed from the SSMF, the retention of capital gains in the portfolio has allowed the SSMF corpus to grow steadily over time. Since Fiscal Year 2004, the corpus of the SSMF has grown from $59.1 million to $68.0 million -- an increase of $8.9 million or 15.1%.

2013	2012	2011	2010	2009	2008	2007	2006	2005	2004
$68.2	*$66.63*	*$64.50*	*$61.70*	*$56.72*	*$60.84*	*$61.63*	*$59.42*	*$60.94*	*$59.07*

It bears noting that the preservation of the corpus has been achieved through some unprecedented and tumultuous market environments, including the Great Recession. In fact, the SSMF has outperformed its benchmark consistently over the last decade:

	Market Value as of 12/31/13	*1 Year*	*3 Year*	*5 Year*	*7 Year*	*10 Year*	*15 Year*
SSMF	$70.7 million	5.81	7.10	9.39	6.15	5.93	6.05
Customized Benchmark		5.60	6.55	6.93	6.07	5.54	5.75

Funds invested to ensure sufficient distributions

Prior to 2012, the asset allocation was very conservative (90% fixed income; 8% equities; and 2% cash). This assumed an income generation (or "yield") of 2.5%, a total return of 3.2%, an expected risk (volatility) of 4% and inflation at 2.1%. This conservative asset allocation allowed the SSMF to generate income while also protecting the portfolio during a very volatile period of equity market returns. But it also projected that the real corpus of the fund would decline over time after inflation and distributions.

In 2012, with interest rates at their lowest levels in decades, the asset allocation was revised to better position the fund for real growth. Specifically, the asset allocation was changed to the following:

15% US Equities
11% Developed Market International Equities
4% Emerging Market Equities
67% Core Fixed Income
3% Cash

Importantly, this new allocation did not alter the projected income generation capacity of the fund (2.5%) but did increase the target return to 5.0% (with a projected volatility of 7.0%). This has positioned the fund to participate in rising equity markets.

Impact of revised asset allocation on distributions and total returns

Since the asset allocation change in September, 2012 through December 31, 2013, the portfolio has returned 5.99%. Had this allocation not been changed, the total return would have only been 1.27% - or 4.72% less than the actual returns based on the current allocation. The portfolio would have distributed about $2.1 million during Fiscal Year 2013, instead of $1.9 million had the asset allocation not been changed, a difference of about $200 thousand. To put it another way, the modestly higher distribution in 2013 (from not changing the asset allocation) would have come at the expense of the SSMF's growth in market value. The current asset allocation policy seeks to balance the need for current income while ensuring long term growth.

Given the level of interest rates today, and the current valuations in the fixed income markets, it may be short sighted to have a disproportionately high allocation to traditional income generating securities such as bonds. Over the past five years, the SSMF, as of December 31, 2013, has returned 9.39% on average. The Barclays Aggregate, a US core fixed income index, has returned 4.44% and the one month LIBOR, a cash equivalent benchmark, has returned just 26 basis points or .26%. As can be seen below, the SSMF has been able to meaningfully outperform fixed income markets:

Returns as of December 31, 2013

	1 year	**3 year**	**5 year**	**7 year**	**10 year**
SSMF	5.81%	7.10%	9.39%	6.15%	5.93%
Barclays Agg	-2.02%	3.26%	4.44%	4.91%	4.55%
1-mo LIB	0.19%	0.22%	0.26%	1.33%	1.90%

Long Term Outlook

Because the fund is structured to distribute all interest and dividends annually, less money is reinvested in the markets, thereby hindering long term growth of the corpus. The challenge for the SSMF is to generate sufficient returns to meet spending needs while ensuring no erosion of the corpus in real terms and while minimizing volatility. This requires the asset allocation to maintain a conservative bent with a large allocation to core fixed income instruments.

Going forward, an appropriate asset allocation policy will depend on how important it is to maintain the value of the corpus over time and/or to prevent the portfolio from significant downside risk. If the current asset allocation is maintained, and preservation of capital remains a priority, annual distributions will need to remain just below the current proposal of a $2 million annual spending policy. If a $2 million annual spending policy were implemented, there is likely to be erosion of the corpus, but it is projected to be fairly modest. However, any distributions at levels above $2 million will require either a readjustment of the asset allocation and assumption of increased risk, or accepting that the fund value will more than likely decline in value over time.